Summary of Testimony of
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Federal Energy Regulatory Commission
888 First St., N.E., Washington, D.C.; (202) 208-1000
on
Competitive Issues in Electricity Deregulation
before the
Committee on the Judiciary
United States House of Representatives
July 28, 1999

Competition is growing in bulk power markets, in response to the Energy Policy Act of 1992 and the Federal Energy Regulatory Commission's efforts to remove barriers to competition and to let markets -- not regulators -- determine the price of wholesale power. Competition in wholesale markets among generators and other sellers of electric energy encourages the development of innovative services and supply options, and ultimately reduces prices for end users. Targeted regulation remains important, however, because market power can be exercised to the detriment of effective competition, raising prices to customers. Market power may take many forms, including control of transmission facilities necessary to deliver electricity and concentration in generation markets.

Ensuring access to transmission services is an essential component of a policy favoring competitive wholesale power markets. In the Energy Policy Act of 1992, Congress gave the Commission effective authority to require transmission services on a case-by-case basis. The Commission, in 1996, took the next step by requiring all public utilities to offer non-discriminatory transmission services. Further statutory changes to ensure open access to a reliable and efficiently-operated transmission grid should be a priority in any legislative reform. In particular, legislation should: bring all transmission facilities in the lower 48 states within the Commission's open access transmission authority; reinforce the Commission's authority to promote regional management of the transmission grid through regional transmission organizations; and, establish a fair and effective program for ensuring the reliability of the transmission grid.

In addition, any electricity legislation considered by Congress should ensure that appropriate and effective tools are available to address other market power issues. The Administration's proposed bill, for example, would close the gap in the Commission's jurisdiction over mergers involving only generation facilities, and clarify that holding companies with electric utility subsidiaries cannot merge without Commission review. The Administration's bill also would give the Commission explicit authority to address market power outside the context of mergers.

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Mr. Chairman and Members of the Committee:

Good morning. My name is Douglas Smith, and I am the General Counsel for the Federal Energy Regulatory Commission. I am here today as a Commission staff witness, and do not speak for the Commission itself or for individual members of the Commission. Thank you for the opportunity to appear before you today to discuss competition issues in electricity markets.

I. Introduction

The Federal Energy Regulatory Commission (Commission or FERC) is actively promoting competition among generators and other sellers of electric energy in the wholesale or "bulk power" market, in furtherance of the goals of the Energy Policy Act of 1992. To achieve those goals, the Commission's fundamental regulatory objectives are: (1) to substitute competition for price regulation in wholesale power markets to the extent possible; and (2) to regulate transmission facilities so as to enable competition in power markets. Market power, however, can be exercised to the detriment of effective competition and consumer interests. Thus, the Commission regulates transmission service, mergers, and wholesale power rates so as to prevent the exercise of market power in bulk power markets.

A key Congressional goal in enacting the Federal Power Act (FPA) was to protect utility ratepayers from abuses of market power. In furtherance of this goal, Congress directed the Commission to oversee sales for resale of electric energy and transmission service provided by public utilities in interstate commerce. Under FPA sections 205 and 206, the Commission must ensure that the rates, terms and conditions of these services are just, reasonable, and not unduly discriminatory or preferential. Under section 203, the Commission must review proposed mergers, acquisitions and dispositions of jurisdictional facilities by public utilities, and must approve such transactions if they are consistent with the public interest. The Commission's jurisdiction under these sections applies only to "public utilities," a category including principally investor-owned utilities and excluding the federal power marketing administrations, cooperatives financed by the Rural Utilities Service and municipal utilities.

In exercising its statutory responsibilities, the Commission must consider the pro-competition policies that underlie the antitrust statutes. This responsibility is not found on the face of the FPA, but rather has been made clear in cases decided by the United States Supreme Court and the courts of appeal. E.g., Gulf States Utilities Co. v. FPC, 411 U.S. 747 (1973). By considering possible anticompetitive effects, the Commission serves as a "first line of defense against those competitive practices that might later be the subject of antitrust proceedings." Id., at 760. The Commission does not apply or enforce the antitrust laws. Rather, consideration of effects on competition is one facet of the Commission's consideration of the FPA's broad statutory standards.

My testimony addresses three principal areas in which the Commission considers anticompetitive concerns: the rates, terms and conditions of transmission in interstate commerce; market-based rates for wholesale sales of generation; and mergers and other corporate realignments involving public utilities.

II. Competition Issues in Electricity Markets

The traditional regulatory approach was to accept that electric utilities were natural monopolies, and to address market power and protect ratepayer interests by relying primarily on cost-of-service rate regulation. In the 1980s and early 1990s, however, several developments indicated that the interests of utility ratepayers could be better protected by competition in wholesale power markets than by cost-based regulation. For example, the benefits of replacing traditional regulation with competition were increasingly evident in other industries, such as trucking, railroads, long-distance telecommunications and natural gas. In the Energy Policy Act of 1992, Congress strongly endorsed competition in wholesale power markets, by providing the Commission with effective authority to order transmission owners to deliver power for other buyers and sellers in the wholesale market, and by reforming the Public Utility Holding Company Act to eliminate a key barrier for new generators entering these markets.

Consistent with these changes, the Commission's primary focus has shifted from cost-based ratemaking to creating the conditions for robust competition. This transition has required the Commission to pay increasing attention to issues of market power. Market power may take many forms, including control of access to transmission facilities necessary to deliver electricity and concentration in generation markets.

Market power problems can result in higher prices to customers. For example, absent regulation, a vertically-integrated utility could prevent its competitors in wholesale power markets from using its transmission facilities to deliver power to buyers. Buyers then would have fewer competitive options and, as a result, may have to pay higher prices. Similarly, a utility with a large enough share of the generating capacity in a market could raise prices by withholding supply from the market. A utility that controls enough of an input to power production (such as pipeline capacity for delivering natural gas to power plants) could achieve the same result.

A. <u>Transmission Access</u>

Market power considerations related to ownership and control of transmission facilities are at the core of the Commission's open access transmission policies. Fair and open access to reliable transmission service is an essential predicate to competition in bulk power markets. Effective regulation of the relatively small transmission sector (which accounts for less than 10% of overall utility costs) enables competition, with its consequent ratepayer benefits, in the much larger generation sector (which accounts for more than 60% of total utility costs).

In the Energy Policy Act of 1992, Congress provided the Commission with effective authority under section 211 of the FPA to require transmission service on a case-by-case basis. This legislation, as implemented by the Commission, helped to expand the trading opportunities of wholesale sellers and buyers. However, the Commission concluded that competition in wholesale markets still was being inhibited by the lack of non-discriminatory access to transmission facilities. Generation sellers owning transmission facilities were stifling competition by discriminating against competing sellers that sought to use their transmission facilities, either by denying or delaying transmission service or by imposing discriminatory rates, terms and conditions for service. The Commission recognized that, if it was to fulfill the Congressional goal of developing competitive wholesale markets, it needed to act generically under section 206 of the FPA to provide for open access transmission.

Consequently, the Commission in 1996, through a major rulemaking called Order No. 888, ordered open (i.e., available to all wholesale users) non-discriminatory access to the transmission facilities of public utilities. This open access obligation prohibits public utilities from discriminating against competitors' transactions in favor of their own wholesale sales of power. Order No. 888 has enhanced competition in wholesale power markets significantly.

This open access obligation, however, applies only to transmission facilities owned or operated by public utilities. Approximately one-third of the transmission grid in the contiguous 48 States is not subject to the Commission’s open access requirements.

This third of the grid is owned primarily by federal power marketing administrations, cooperatives financed by the Rural Utilities Service, and municipal utilities. While some of these entities offer open access transmission service voluntarily, many others do not. These gaps in open access to the transmission grid can impede the development of full competition in wholesale power markets, and should be closed through legislation making all utilities subject to the same open access requirements.

In Order No. 888, the Commission also encouraged, but did not require, the formation of independent system operators (ISOs) to promote broader, regional power markets and provide greater assurance of non-discrimination. Since then, six ISOs have been established (in California, the mid-Atlantic states, New England, New York, the Midwest and Texas). Four of these are currently operational.

The Commission is seeking further improvements in transmission access and grid operation to support fully competitive wholesale power markets. Of particular importance, the Commission has proposed new rules to promote the formation of regional transmission organizations (RTOs) such as ISOs and independent companies that own and operate transmission facilities (transcos). Notice of Proposed Rulemaking on Regional Transmission Organizations, 64 Fed. Reg. 31,389, FERC Stats. & Regs., ¶ 32,541 (1999). An RTO should be independent of the financial interests of power market participants, cover an appropriately configured region, and have adequate operational control over the transmission grid. If properly designed, an RTO can provide greater assurance of non-discriminatory operation of the transmission grid, eliminate pancaked transmission charges for using transmission systems owned by different utilities, reduce and better manage congestion on the transmission lines, and facilitate transmission planning on a multi-state basis. Legislation can help reinforce the Commission's authority to require the formation of, and participation in, RTOs as appropriate to promote the efficient regional management of the transmission grid.

The changes in the industry in recent years also have created a need for new tools for ensuring the reliability of the transmission grid. In the past, reliability was ensured through the voluntary cooperation of industry participants. Today, industry participants increasingly recognize that voluntary, cooperative efforts may not be sufficient, and that a mandatory system of ensuring the reliability of the grid is needed. This recognition has caused the industry to begin seeking the Commission's involvement on reliability issues, despite the Commission's lack of a clear statutory role on such issues.

Congress should make compliance with appropriate reliability standards mandatory. There appears to be an industry consensus that it can continue to work collaboratively to develop reliability standards, using a process in which all market sectors are fairly represented. Sufficient Federal oversight will be needed to ensure that the standards maintain sufficient system reliability and are not unduly discriminatory or otherwise anticompetitive.

In summary, electricity legislation should: bring all transmission facilities in the lower 48 states within the Commission's open access transmission authority; reinforce the Commission's authority to promote efficient regional management of the transmission grid through RTOs; and, establish a fair and effective program to protect the reliability of the transmission grid. Addressing these transmission-related issues should be a priority in any legislative reform agenda.

B. Market-Based Rates for Power Sales

To promote competition, the Commission allows market-based rates for wholesale sales of electricity when an applicant shows that it and its affiliates lack, or have mitigated, market power. In evaluating horizontal market power for these purposes, the Commission distinguishes between new generating facilities and existing facilities. For sales from new generating facilities, the Commission applies a rebuttable presumption that the applicant lacks generation market power, but intervenors may present specific evidence to the contrary. For sales from existing generating facilities, the Commission uses a case-specific analysis of whether the applicant and its affiliates control a significant share of the total generation capacity that can be accessed by the utilities directly interconnected to the applicant or its affiliates.

In evaluating vertical market power for these purposes, the Commission considers the extent of the applicant's control of any inputs to power production. Most applicants for market-based rates lack significant control of such inputs and thus present no vertical market power concerns. The Commission analyzes the control of transmission facilities separately from other sources of vertical market power and, for purposes of market-based rates, currently accepts compliance with Order No. 888's open access requirements as adequate mitigation of transmission market power.

Should the Commission identify market power problems after market-based rates have been authorized, it can revoke market-based rates and return to cost-of-service regulation. This remedy does not eliminate the underlying market power but, instead, relies on price regulation to mitigate the potential for its exercise.

C. <u>Merger Review</u>

Market power can be created or enhanced by mergers. Mergers can eliminate a competitor from the market and concentrate control of generating assets. Mergers can also enhance vertical market power, by giving the merged company a new or increased ability and incentive to restrict inputs to power production.

The Commission considers market power issues in reviewing applications for mergers or other jurisdictional acquisitions or dispositions of assets. In a merger policy statement issued in 1996, the Commission stated that, in assessing whether a proposed merger was in the public interest, it would consider the effects of the merger on competition, on rates and on regulation.

The Commission adopted the Department of Justice/Federal Trade Commission merger guidelines as the framework for analyzing a merger's horizontal effects on competition. These guidelines set out five steps for analyzing mergers, based on: (1) whether the merger would significantly increase market concentration; (2) whether the merger would result in adverse competitive effects; (3) whether entry would mitigate the merger's adverse effects; (4) whether the merger would result in efficiency gains not achievable by other means; and (5) whether, absent the merger, either party would likely fail, possibly causing its assets to exit the market.

The Commission's merger policy statement also described a conservative analytical screen for quickly identifying mergers unlikely to raise horizontal market power concerns. The screen analysis focuses on the first step identified in the DOJ/FTC guidelines, i.e., whether the merger would significantly increase concentration. The screen analysis defines relevant markets by identifying suppliers that can deliver power to affected customers at competitive prices. If the screen analysis shows that the merger-related increase in market concentration is less than certain specified amounts, the Commission will not set the matter for hearing to further consider competitive effects.

The Commission's analysis of vertical market power concerns is similar. A vertical merger is unlikely to harm competition unless the merged company has the incentive and the ability to affect prices or quantities in the upstream (input) market and the downstream (electricity) market. For example, a company may be able, and have an incentive, to restrict service or raise prices for an input such as natural gas pipeline capacity and, as a result, restrict service or raise prices in supplying wholesale power.

If a merger will create market power or enhance the applicants' market power significantly, mitigation of these effects is required in order to ensure that the merger is consistent with the public interest. Section 203 of the FPA gives the Commission authority to approve a merger subject to "such terms and conditions as it finds necessary or appropriate to secure the maintenance of adequate service and the coordination in the public interest of facilities subject to the jurisdiction of the Commission."

The Commission's jurisdiction over mergers and acquisitions is limited in certain ways. First, the Commission has no direct jurisdiction over transfers of generation facilities. It can review transactions involving a public utility only when they involve other facilities that are jurisdictional (such as transmission facilities or contracts for wholesale sales). Thus, although concentration of generation assets may directly affect competition in wholesale markets, transactions involving only generation assets may not be subject to FPA review.

Second, the Commission lacks direct jurisdiction over mergers of public utility holding companies. While the Commission has construed such mergers to involve jurisdictional indirect mergers of public utility subsidiaries of the holding companies, or changes in control over the jurisdictional facilities of the public utility subsidiaries, the FPA is not explicit on this point.

These jurisdictional gaps could be usefully addressed in the course of legislative reform.

D. <u>Legislative Reforms on Competition Issues</u>

As we seek to rely primarily on competition as opposed to traditional price regulation to protect the interests of ratepayers, regulators must have the range of tools necessary to address market power problems that may threaten competition. Reforms to the Federal statutory scheme are appropriate to permit regulators to keep up with new market power challenges.

The Administration's proposed bill (H.R. 1828) addresses market power issues comprehensively. With respect to transmission, the bill would extend the Commission's open access authority to non-public utilities in the lower 48 States, would reinforce the Commission's authority to achieve efficient regional management of the transmission grid through RTOs, and would establish a fair and effective program of mandatory reliability standards. The Administration's bill also would close the gap in the Commission's jurisdiction over mergers involving only generation facilities, and would clarify that holding companies with electric utility subsidiaries cannot merge without Commission review. The bill would further authorize FERC to address market power in retail markets, if asked by a state commission lacking adequate authority to address the problem itself, and in wholesale markets by requiring a public utility to file and implement a mitigation plan. Each of these reforms would be an important tool for promoting competitive electricity markets.

III. Conclusion

Competition is growing in the electric industry, in response to the Energy Policy Act of 1992 and the Commission's efforts to remove barriers to competition and to let markets -- not regulators -- determine the price of wholesale electric power. Competition in electricity markets will not protect ratepayers effectively, however, if some market participants can exercise market power. Thus, as we continue to move toward more competitive power markets, we must ensure effective regulation of transmission facilities and the mitigation of market power. These issues require careful attention by the Congress, the Commission, the antitrust agencies and our State counterparts. The Federal statutory regime should protect consumers by combining pro-competitive policies with the regulatory tools necessary to constrain market power effectively.

Thank you again for the opportunity to offer my views here this morning. I would be pleased to answer any questions you may have.